United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7412

United States Court of Appeals

For the Second Circuit.

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P/S

SYLVIA SACKS and BENJAMIN M. SACKS, individually as joint tenants, DONALD W. HAGELE, individually and as representatives and Class Members of Stockholders of INTERSTATE STORES, INC. who purchased their shares subsequent to Christmas 1973, ROBERT G. MORRIS, individually, ROBERT G. MORRIS, MARIKAY MORRIS and J. BRECK TOSTEVIN, as Trustees for ROBERT G. MORRIS DDS INC. EMPLOYEES PENSION TRUST, BABETTE KENT, individually, JEROME KENT and BABETTE KENT as joint tenants, JEROME KENT, individually, and MORRIS L. [illegible]ANOVITZ, individually and as representatives and Class Members of Bondholders of INTERSTATE STORES, INC. who purchased their bonds subsequent to Christmas 1973, and in behalf of all other persons similarly situated and circumstanced,

Plaintiffs-Appellants,

-against-

INTERSTATE STORES, INC., MERSHULAM RIKLIS, CHARLES P. LAZARUS, ALBERT PARKER, SAM J. ABEND, WALTER A. CRAIG, SAMUEL HAUSMAN, M. LESTER MENDELL, EDWARD C. SCHENKEL, HAROLD J. SZOLD, ROBERT C. VAN TUYL, and "JOHN DOE" and "RICHARD ROE", the names "JOHN DOE" and "RICHARD ROE" being fictitious, the parties intended being those individuals, firms, corporations and associations who obtained material non-public information to the effect that in Christmas 1973 the said INTERSTATE STORES, INC. was "devoid of credit" and who either utilized this information for its own account or transmitted it to third parties who utilized this information for their own account,

Defendants-Appellees.

On Appeal From The United States District Court For The Eastern District Of New York

APPELLANTS' BRIEF

BADER AND BADER
Attorneys for Plaintiffs-Appellants
274 Madison Avenue
New York, N.Y. 10016
(212) 532-6860

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SYLVAI SACKS and BENJAMIN M. SACKS, individually and as joint tenants, DONALD W. HAGELE, individually and as Class Members of Stockholders of INTERSTATE STORES, INC. who purchased their shares subsequent to Christmas 1973, ROBERT G. MORRIS, individually, ROBERT G. MORRIS, MARIKAY MORRIS and J. BRECK TOSTEVIN, as Trustees for ROBERT G. MORRIS DDS, INC. EMPLOYEES PENSION TRUST, BABETTE KENT, individually, JEROME KENT and BABETTE KENT, as joint tenants, JEROME KENT, individually and MORRIS L. JANOVITZ, individually and as representatives and Class Members of Bondholders of INTERSTATE STORES, INC, who purchased their bonds subsequent to Christmas 1973 and in behalf of all other parties similarly situated and circumstanced,

No. 75-7412

Plaintiffs-Appellants

against

INTERSTATE STORES, INC., MERSHULAM RIKLIS, CHARLES P. LAZARUS, ALBERT PARKER, SAM J. ABEND, WALTER A. CRAIG, SAMUEL HAUSMAN, M. LESTER MENDELL, EDWARD C. SCHENKEL, HAROLD J. SZOLD, ROBERT C. VAN TUYL and "JOHN DOE" and "RICHARD ROE", the names "JOHN DOE" and "RICHARD ROE" being ficticious, the parties intended being those individuals, firms, corporations and associations who obtained material non-public information to the effect that in Christmas 1973 the said INTERSTATE STORES, INC. was "devoid of credit" and who either utilized this information for its own account or transmitted it to third parties who utilized this information for their own account

Defendants-Appellees

APPELLANTS' BRIEF

This is an appeal from an Order of HON. WALTER BRUCHHAUSEN, one of the Jusges of the United States District Court for the Eastern District of New York who dismissed the Complaint herein pursuant to Rule 12 FRCP. The appellants believe that this determination is incorrect and therefore appeal to this Court. The District Judge further refused to permit the plaintiffs to amend their complaint.

APPELLANTS' POINTS

1. Under the controlling law of this Court, as enunciated in Schlick vs. Penn-Dixie Cement Corporation since the facts relating to the fraud are peculiarly within the knowledge of the defendants the rule with respect to the pleading of fraud claims with particularity is relaxed and the claims are sufficiently pleaded in the Complaint herein.

2. The District Court, in any event, erred in failing to permit the plaintiffs leave to amend their complaint to specify the fraud involved or to permit discovery with respect to the details thereof.

3. The mere failure to file the required 8-K report on behalf of the defendant INTERSTATE STORES, INC. with the Securities and Exchange Commission in connection with the said defendant being "devoid of credit" in Christmas 1973 is, in and

of itself, a securities violation.

ANALYSIS OF THE COMPLAINT

The Complaint in this action (App. 7-22) contains in effect, three separate causes of action. Count One of the Complaint is an action under the Securities Exchange Act of 1934, and in particular the "common or garden" Rule 10B-5 action. The Count is broader, however, and also accuses the defendants of failing to file proper reports and/or the filing of misleading reports. In general the allegations of Count One (which must be taken as true) allege that the trade crefit of the defendant INTERSTATE STORES, INC. was cut off in December 1973 and that, subsequent to that time, the said defendant was on a COD basis with their suppliers (Paragraph 15, App-13), that this information was material non-public information which should have been disclosed to security holders of INTERSTATE STORES, INC and to the public but was not so disclosed(Paragraph 17, App-13), that the information was made available by the defendants to various favored individuals who then sold their holding of INTERSTATE STORES, INC. securities to the public based upon the said inside information (Paragraph 19 (App 13,14), that the defendants knew that the publicly touted "merger" between INTERSTATE STORES and MC CRORY CORPORATION was not going to take place because of the poor financial condition of INTERSTATE STORES, INC.

(paragraph 21 App-12), but that this information was not promptly revealed to the public, that INTERSTATE STORES, INC, commenced bankruptcy proceedings in May 1973 but that the defendants knew as early as December 1973 that such bankruptcy proceeding would have to be commenced but did not reveal this information to the public. Damages and refund of the purchase price of the securities purchased by the holders who purchased the said securities between December 1973 and May 1974 is requested.

Count Two of the Complaint is similar to Count One but is brought in behalf of the bondholders of INTERSTATE STORES, INC. who purchased their bonds between December 1973 and May 1974.

Count Three of the Complaint is a pendent common-law fraud claim and, it is conceded, that if the Securities Claims cannot be sustained the pendent fraud claims also cannot be sustained.

Count Four of the Complaint is also a pendent common-law fraud claim.

ANALYSIS OF THE DECISION OF THE DISTRICT COURT

District Judge Bruchhausen, in dismissing the Complaint herein, held that the amended complaint alleged "nothing more than sheer speculation that the actions of the

defendants constituted violations of the security laws, rules and regulations". The Court cited Segal vs. Gordon 467 Fed.(2nd) 602 as authority for this action.

POINT ONE

UNDER THE CONTROLLING LAW OF THIS COURT, AS ENUNCIATED IN SCHLICK vs. PENN-DIXIE CEMENT CORPORATION SINCE THE FACTS RELATING TO THE FRAUD ARE PECULIARLY WITHIN THE KNOWLEDGE OF THE DEFENDANTS THE RULE WITH RESPECT TO THE PLEADING OF FRAUD CLAIMS WITH PARTICULARITY IS RELAXED AND THE CLAIMS ARE SUFFICIENTLY PLEADED IN THE COMPLAINT HEREIN

It is, of course, "hornbook law" that a fraud comolaint must be pleaded with particularity. It will not suffice, for example, to make a naked allegation that the defendants defrauded the plaintiff. This is not what the present complaint alleges:

The Complaint alleges knowledge of material non-public information by the defendants, the utilization of this information on the defendants own account or the communication thereof to third parties who utilized this on their own account and damages caused thereby since the plaintiffs are purchasers of INTERSTATE STORES securities after the adverse information was known to the defendants but before it was disclosed to the public.

That such action is actionable under Rule 10B-5 of the Rules of the Securities and Exchange Commission is well settled law as the Texas Gulf Sulphur determination has clearly held.

Apparently, as far as the plaintiffs can determine, the District Court held the Complaint insufficient because the plaintiffs did not specifically set forth the identity of the third parties who utilized the inside information for their own behalf. This information, at the present time, is not known to the plaintiffs. Discovery, even to the limited extent permitted by interroagatories, has not been had and interrogatories (App 5,6) addressed to the defendants have not been answered. If the Court is going to require a specification of fraud to the extent suggested by the District Judge, then, in most "insider cases" it will be impossible for the public to obtain redress from such actions. As the famous State Prosecutor Nadjari stated on many occasions "fraud is not committed in Macy's window on Thirty-Fourth Street."

In the opposing affidavit (App.25-27) plaintiffs revealed that in Jamuary 1974 the sales of Interstate securities on the New York Stock Exchange was far in excess of normal volume.

The specific sales information was subsequently obtained from the New York Stock Exchange and will be submitted to the Court on the argument of this appeal. Quite obviously, in January 1974 somebody knew something and took advantage of it to the detriment of the General Public who , not knowing the information involved, purchased overvalued INTERSTATE STORES securities.

This Court, subsequent to the Gordon determination did speak on questions similar to those raised in the case at bar. In Schlick vs. Penn-Dixie Cement Corporation, 507 Fed.(2nd) 374 (379) [1974] where this Court said:

> " * * * the particularity requirement may be satisfied if, as here, the allegations are accompanied by a statement of the facts upon which the belief is founded.* * *"

The Court also cited Carroll vs. First National Bank of Lincolnwood, 413 Fed(2nd) 353 and Brady vs. Games 128 Fed(2nd) 754 as indicating that the "particularity rule" was sufficiently complied with without the pleading of evidence.

Schlick also seems to partially overrule Segal vs. Gordon in stating that a 10B-5 case is broader than a common-law fraud case and requires a relaxed standard of proof for such fraud. (See the footnote on page 378 of the Court's opinion).

Thus, under the facts set forth in the case at bar, the necessary allegations have been made and the District Judge

was in error in dismissing the Complaint.

POINT TWO

THE DISTRICT COURT, IN ANY EVENT, ERRED IN FAILING TO PERMIT THE PLAINTIFFS LEAVE TO AMEND THEIR COMPLAINT TO SPECIFY THE FRAUD INVOLVED OR TO PERMIT DISCOVERY WITH RESPECT TO THE DETAILS THEREOF.

Plaintiffs, in connection with the Rule 12 motion, submitted an affidavit to the Court. This affidavit specifically stated (App. 25)

> "* * * However, in the event that this Court should feel that more detail is required than is set forth in the Complaint the plaintiffs respectfully request leave to amend the Complaint to set forth the additional details set forth herein.* * "

The Opposing Affidavit pointed out that in January 1974 the volume of sales of INTERSTATE STORES securities far exceeded normal volume. The Record in this case also shows unanswered interrogatories which would have revealed significant details of the claims involved.

We thus have a policy consideration before this Court. Plaintiffs have purchased large volumes of securities of a corporation which was considered to be a bad credit risk prior to the purchases. Material information with respect to the credit

of the issuer was deliberately and admittedly withheld from the public. The volume of sales of the securities rapidly increased almost immediately thereafter. This is, of course, all the information a plaintiff has to go on. Does not that justify the filing of a Complaint and permit the discovery processes of this Court to proceed to obtain the details? Or does the Court believe that unless a fraud is committed "In Macy's Window" a plaintiff has no redress. This is the question presented to this Court.

POINT THREE

THE MERE FAILURE TO FILE THE REQUIRED SEC 8-K REPORT ON BEHALF OF THE DEFENDANT INTERSTATE STORES, INC. WITH THE SECURITIES AND EXCHANGE COMMISSION OR TO MAKE A PUBLIC STATEMENT WITH RESPECT TO THE FACT THAT INTERSTATE STORES, INC. WAS DEVOID OF CREDIT IN DECEMBER 1973 IS, IN ITSELF, A SECURITIES VIOLATION.

This case, aside from the "fraud" aspects, involved another issue that was not considered by the District Judge. Does not the failure to disclose a material matter to the public (even though it is not disclosed to third parties) constitute, in and of itself, a Securities Violation. The Securities and Exchange Commission has rules which require the filing of an 8-K report if there are certain material matters which occur in connection with the business of an issuer of securities.

However, even in the absence of specific requirements is not the fact that a retailer has had its trade credit cut off such a material matter that security purchasers are entitled to know such facts. And is not the failure to disclose such facts promptly so that prospective purchasers of securities have such information in their possession to make an informed decision as to the purchases of such securities a clear "artifice or scheme to defraud" or an act which defrauds a purchaser of securities? And, if this is so, is not the Complaint involved sufficient?

CONCLUSION

THE DETERMINATION OF THE DISTRICT COURT DISMISSING THE COMPLAINT HEREIN SHOULD BE IN ALL RESPECTS REVERSED, OR IN THE ALTERNATIVE, THE PLAINTIFFS SHOULD BE PERMITTED TO AMEND THEIR COMPLAINT AFTER DISCOVERY IS COMPLETED IN THIS ACTION.

Respectfully submitted

BADER and BADER
Attorneys for Plaintiffs
270 Madison Avenue
New York NY 10016
532-6860

I, I. WALTER BADER hereby certify that on Sept 29, 1975 I served 3 copies of the foregoing brief upon PARKER, CHAPIN & Flattau attorneys for Appellees.

I. Walter Bader